Supreme Court, U.S.
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No. 94-729

In the Supreme Court of the United States

OCTOBER TERM, 1994

GARY E. KRAUSE, TAX MATTERS PARTNER, BARTON ENHANCED OIL PRODUCTION INCOME FUND, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

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QUESTION PRESENTED

Whether the Barton Enhanced Oil Production Income Fund partnership did not engage in oil and gas exploitation activities with the actual and honest objective of deriving a profit (as opposed to generating tax writeoffs) and whether the losses reported by this partnership and claimed by petitioner and the other partners as deductions on their individual returns were therefore properly disallowed.

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OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 154-173) is reported at 28 F.3d 1024. The opinion of the United States Tax Court (Pet. App. 1-153) is reported at 99 T.C. 132.

JURISDICTION

The judgment of the court of appeals was filed on June 22, 1994. On September 14, 1994, Justice Ginsburg granted an extension of time to and including October 20, 1994, in which to file the petition for a writ of certiorari. The petition was filed on October 20, 1994. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

1. The Commissioner of Internal Revenue issued a notice of final partnership administrative adjustment disallowing losses and amounts claimed as eligible for investment tax credits by the Barton Enhanced Oil Production Income Fund for its 1982 and 1983 taxable years. Gary E. Krause, Tax Matters Partner of the partnership, petitioned the Tax Court for redetermination of the adjustments.

The Tax Court treated the case as a test case for the Elektra/Hemisphere Shelter group, consolidating it with that of R.A. Hildebrand and Dorothy A. Hildebrand Wahl for trial and opinion. R.A. Hildebrand was a partner in the Technology Oil and Gas Associates-1980 partnership, another member of the Elektra/Hemisphere group. Following a 15-week trial, the Tax Court issued its opinion upholding substantially all of the Commissioner's determinations. Under Section 183(a) of the Internal Revenue Code, 26 U.S.C. 183(a), the Tax Court disallowed the losses claimed by the partnerships because they did not have the requisite profit motive in engaging in their activities (Pet. App. 131). The court also disallowed claimed interest deductions under Section 163 of the Code because the underlying debt obligations of the partnerships were not genuine (Pet. App. 130-131). Finaly, under Sections 6601 and 6621(c) of the Code, the Tax Court upheld the Commissioner's application of the increased interest rate applicable to tax underpayments attributable to tax-motivated transactions (Pet. App. 141-144).

The Tax Court's rulings were based on its findings that: (i) the amounts that the partnerships agreed to pay for licenses for enhanced oil recovery (EOR) technology and for a lease of tar sands properties from which oil was

to be extracted "bore no relation to the value of that which was acquired, did not conform to industry norms, and precluded any realistic opportunity for profit" (Pet. App. 109-110); (ii) the partnerships' estimates of oil to be recovered through EOR technology were "not supported by credible expert testimony * * * and were not reasonable" in light of the undeveloped and untested status of the EOR technology (*id.* at 110); (iii) the economic projections in the offering materials used by the partnerships reflected a series of unsubstantiated assumptions that did not account for the abnormal cost of the license fees and royalties or the significant cost of establishing commercial operations (*id.* at 111-112); (iv) all but two of the EOR technologies licensed by the partnerships were "undeveloped, untested processes for which no prudent investor would pay any substantial fixed fees," and the other two technologies could have been licensed based solely on the income realized therefrom (*id.* at 117); (v) the partnerships relied on unrealistic projections that "world oil prices would continue increasing from 1979 and 1980 prices on a continuing upward spiral for the next 20 years" (*id.* at 125); (vi) the licensing agreements for the EOR technologies were not the product of arm's-length negotiations (*id.* at 130); and (vii) the partnerships were heavily promoted and marketed on the basis of projected tax benefits and inaccurate information regarding the EOR technology (*id.* at 108-109, 111-112).

2. The court of appeals affirmed (Pet. App. 154-173). The court of appeals concluded that the Tax Court correctly held under Section 183(a) that losses from the partnerships' transactions are not deductible unless those activities were engaged in with the actual and honest objective of making a profit (Pet. App. 163). The court noted that whether the partnerships had an actual

and honest profit objective is a question of fact to be reviewed only for clear error (*id.* at 161.) The court of appeals concluded that "[t]he Tax Court did a thorough job of considering the profit motive issue. It applied the relevant factors, considered all the evidence and testimony presented and rested its determination on a solid foundation." *Id.* at 169-170. The court of appeals similarly concluded that the Tax Court's findings that the partnerships' debt obligations were not genuine and that the transactions were tax-motivated were not clearly erroneous (*id.* at 170-171).

ARGUMENT

The decision of the court of appeals is correct and does not conflict with any decision of this Court or any other court of appeals. Further review is therefore not warranted.

1. Under the general provisions of Section 183(a) of the Internal Revenue Code, if an "activity is not engaged in for profit, no deduction attributable to such activity shall be allowed" (26 U.S.C. 183(a)). In a lengthy opinion that followed a 15-week trial, the Tax Court found, as a fact, that petitioner's partnership did not engage in oil and gas exploitation activities with an actual and honest objective of making a profit but, instead, that the venture was organized and operated to generate tax losses for the partners far in excess of the amounts of their actual investments in the partnership (Pet. App. 131). The court therefore disallowed the loss deductions reported by the partnership and passed on to petitioner and the other partners. The court of appeals, applying the clearly erroneous standard of review, affirmed the Tax Court's finding that the partnerships' activities lacked a genuine profit motive (*id.* at 169).

Petitioner asserts (Pet. 11-12) that the court of appeals should have reviewed the Tax Court's decision *de novo*. That contention is incorrect, however, because this case involved the fundamentally factual question whether petitioner's partnership had a genuine profit motive or was, instead, nothing more than a tax shelter. The Tax Court's finding that the partnership lacked a bona fide profit motive was quintessentially a finding of fact. It was therefore properly reviewed by the court of appeals under the clearly erroneous standard. The circuit courts have consistently held that a trial court's determination of the existence or non-existence of a profit motive is a factual question to be reviewed only for clear error. See *Wolf* v. *Commissioner*, 4 F.3d 709, 713 (9th Cir. 1993); *Cannon* v. *Commissioner*, 949 F.2d 345, 349 (10th Cir. 1991), cert. denied, 112 S. Ct. 3030 (1992); *Evans* v. *Commissioner*, 908 F.2d 369, 372 (8th Cir. 1990); *Hayden* v. *Commissioner*, 889 F.2d 1548, 1552 (6th Cir. 1989); *Simon* v. *Commissioner*, 830 F.2d 499, 501, 507 (3d Cir. 1987); *Thomas* v. *Commissioner*, 792 F.2d 1256, 1259 (4th Cir. 1986); *Tallal* v. *Commissioner*, 778 F.2d 275, 276 (5th Cir. 1985); *Nickerson* v. *Commissioner*, 700 F.2d 402, 405 (7th Cir. 1983); *Schley* v. *Commissioner*, 375 F.2d 747, 749 (2d Cir. 1967); see also Treas. Reg. § 1.183-2(b) (26 C.F.R.) ("[i]n determining whether an activity is engaged in for profit, all facts and circumstances with respect to the activity are to be taken into account"). This application of the clearly erroneous standard of review reflects the established principle that determinations of intent or motivation are peculiarly within the province of the trial court. See, *e.g.*, *Commissioner* v. *Duberstein*, 363 U.S. 278, 289 (1960).

2. Petitioner also argues (Pet. 13-22) that the Tenth Circuit erred in holding that, to establish that the activities of the partnerships were "engaged in for

profit" (26 U.S.C. 183(a)), the partnership must show that it had a "dominant or primary" profit motive (Pet. App. 163). Petitioner urges that the proper standard is not whether there was a "dominant or primary" profit motive but whether the transaction "had any practical effects other than the creation of income tax losses" (Pet. 21). Petitioner contends that the latter standard was applied in *Smith* v. *Commissioner*, 937 F.2d 1089, 1096 (6th Cir. 1991), and that there is therefore a conflict among the circuits on this legal issue.

Petitioner's claim of a conflict is not correct. It is true that the courts of appeals have articulated varying linguistic versions of the profit motive test under Section 183. See, *e.g.*, *Cannon* v. *Commissioner*, 949 F.2d at 350 ("whether profit was the dominant or primary objective of the venture"); *Smith* v. *Commissioner*, 937 F.2d at 1096 (whether transaction had any "practicable effects other than the creation of income tax losses"); *Malmstedt* v. *Commissioner*, 578 F.2d 520, 527 (4th Cir. 1978) (whether venture was undertaken "in good faith for the purpose of making a profit"). As petitioner acknowledges (Pet. 15-17), however, ten of the circuit courts—including the three listed above—have applied the "actual and honest profit objective" standard that was utilized in this case. No circuit has expressly disagreed with that standard, which requires that the taxpayer establish that the activity giving rise to the claimed deductions had as its motivation a genuine intent to generate an economic profit, as opposed to tax losses (Pet. App. 106, 163). Moreover, as the court of appeals held (*id.* at 163), the record fully supports the Tax Court's finding that the partnerships failed to demonstrate that they had a bona fide profit objective. Under any of the linguistic formulations of the "for profit" test of Section 183(a), the result in this case

would thus be the same. Further review is therefore not warranted.

3. Petitioner further contends (Pet. 22-23) that, even if the partnership lacked an actual and honest profit objective, the courts below erred in not allowing interest deductions, because the debts that gave rise to the deductions were recourse obligations. He relies for this proposition on *Rice's Toyota World, Inc.* v. *Commissioner*, 752 F.2d 89 (4th Cir. 1985), where deductions were allowed for interest paid on recourse debt even though the debt obligations were issued in connection with a transaction that lacked economic substance. In *Rice's Toyota World*, however, the allowance of the interest deductions was based on the court's findings that the debts were "genuine obligations" and that the interest paid reflected "an obligation of economic substance" (752 F.2d at 96). In the present case, by contrast, the Tax Court found that the purported debt obligations were not genuine, and that factual finding was affirmed by the Tenth Circuit (Pet. App. 131, 170).

4. Petitioner makes various other arguments (Pet. 24-47) directed at the factual findings of the Tax Court. The court of appeals carefully reviewed the record and concluded that it could find no error in any of the Tax Court's findings. Further review of petitioner's factual assertions is not warranted. See *Anderson* v. *City of Bessemer City*, 470 U.S. 564, 573-574 (1985).

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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